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ABSTRACT

This booklet for trustees of institutions of higher education offers guidelines to enable trustees to fulfill their fundamental responsibility of ensuring the financial health of the institution. Introductory sections address: challenges of the financial environment in which trustees must make decisions; specific responsibilities of the institution's governing board; and the importance of partnership with the administration. The following section raises four central questions for boards that relate to institutional mission, financial planning, and available resources. A method for comparing the institution's strategic indicators with those of similar institutions is offered. Also noted is the importance of monitoring the data sources used for financial decisions. Among principles highlighted in the booklet are the following: (1) for independent institutions in particular, adequate financing is the key to quality and reputation (as well as survival); (2) ideally, boards should focus on review and authorization, the administration on recommendation and management, and both on evaluation; and (3) over time, the total yearly return, including income and capital gains, of the endowment must be equal to or greater than spending for the budget plus inflation. (DB)

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ED 428 595

BOARD BASICS

FINANCIAL MATTERS

FINANCIAL RESPONSIBILITIES

BY TRACY J. BURLOCK
AND KENT JOHN CHABOTAR

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Financial Responsibilities

Trustees have no greater responsibility than to ensure the financial health of their institutions. To be sure, boards carry out other important duties, but it matters little if institutional leaders have created a forward-looking strategic plan or developed innovative academic programs if the institution struggles from one year to the next simply to survive. Sufficient funds make virtually all institutional initiatives possible.

Attending to the core responsibility—stewardship of the institution's assets in support of the mission—is complicated by many factors. Trustees will recognize these familiar scenarios:

- With the goal of becoming a "national college of distinction," the president proposes a 12 percent tuition increase. The finance committee approves the increase, but the full board lowers it to 10 percent and calls for a higher endowment spending rate to make up the lost revenue.

- After a year-long study, the board votes to close the college's fraternity houses within three years. To preserve the social and community values of some students who joined fraternities, the board also endorses a new residential life plan and housing system. The estimated price tag: $30 million.

- The state's attorney general launches an investigation of presidential compensation in colleges and universities. He discovers one institution is paying for the president's children to attend private school, has bought $33,000 worth of groceries for the president's family, and has purchased the president's home for $220,000 above assessed value.

Such complications—policies with long-term consequences, well-intentioned actions that result in substantial financial commitments, and ill-advised compensation practices—are only a few of the factors to which boards must be alert as they make sound financial policies.

For independent institutions in particular, adequate financing is the key to quality and reputation—to say nothing of survival. In approving the annual budget, the board also is making a fundamental statement concerning the institution's priorities. When an institution allocates a growing share of its budget to teaching and learning and less to administrative overhead, for example, it demonstrates far better than any catalog, press release, or official pronouncement that its budget supports its priorities.

FINANCIAL ENVIRONMENT. The environment in which trustees make financial decisions rarely has been more challenging. Although the public generally approves of the quality of higher education, students and their families shudder at its cost. In the late 1980s and throughout the 1990s, tuition rose faster than family incomes and the standard measure of inflation, the Consumer Price Index. A fundamental reason tuition goes up every year is that the costs of running colleges and universities are high and keep rising, while most colleges' revenue sources other than tuition simply aren't growing fast enough.

Providing high-quality education is expensive. Students and their families expect colleges and universities to provide extensive academic and career counseling services, better access to information technology, and top-flight recreational facilities. The costs of maintaining adequate physical plants, scientific laboratories, and library collections have grown, as has the cost of insurance and making contributions to social security and pension funds. Academic institutions also face increased competition from traditional rivals, vocational and trade schools, corporate-training programs, and distance-education programs.

While students and families are demanding higher quality, many institutions are cutting costs, restructuring their operations, and otherwise changing the way they conduct business. Yet most institutions are unable to justify their costs against the measurable outcomes of a course or degree program. This mystifies many trustees who are accustomed to stringent market and profitability tests for a business's products and services.

FOR INDEPENDENT INSTITUTIONS IN PARTICULAR, ADEQUATE FINANCING IS THE KEY TO QUALITY AND REPUTATION—TO SAY NOTHING OF SURVIVAL.

THE BOARD'S ROLE. In the context of this dynamic and challenging environment, a governing board's responsibility is to chart an institution's course and ensure it has the resources it needs to fulfill its mission. To meet its financial responsibilities, the board must sustain the institution over the long term by doing the following:

- Ensure the institution complies with applicable laws and regulations and protects its tax-exempt status.
- Safeguard institutional autonomy and integrity.
- Monitor long-range strategic and financial planning to ensure adequate resources.
- Review and approve the institution's annual operating budget, appoint auditors, and approve the annual financial statement.
- Preserve the institution's facilities and make capital decisions by authorizing construction, issuing bonds, and ratifying the purchase or sale of property.
- Monitor and oversee the institution's investments and endowment.
- Guide the institution's fund-raising and other development efforts and participate through personal contributions.
- Establish risk-management policies, including adequate insurance coverage and checks and balances over the institution's senior officers.
- Determine compensation levels for chief executives (and senior officers in some institutions) and evaluate chief executives' performance.

Public college and university boards have special financial responsibilities in working with state systems and legislatures in the areas of appropriations, tuition levels, funding formulas, and the use of state authorities to issue bonds.

IDEALLY, BOARDS SHOULD FOCUS ON REVIEW AND AUTHORIZATION, THE ADMINISTRATORS ON RECOMMENDATION AND MANAGEMENT, AND BOTH ON EVALUATION.

PARTNERSHIP WITH ADMINISTRATION. While the board's financial and fiduciary responsibilities are complex and extensive, its role is to *oversee* and *govern* the institution rather than to *manage* it. As longtime board watchers Richard P. Chait and Barbara E. Taylor advise in "Charting the Territory of Nonprofit Boards," in the *Harvard Business Review* (January-February 1989), "Rather than *do* more, boards should *demand* more." Board members should establish the basic financial policies, monitor enforcement, and take the long view of most issues. Day-to-day management of the institution belongs to the administration. This is easier said than done for at least two reasons.

First, distinguishing policy from administration is difficult; policy often is only really understood after it has been implemented and administrative oversight occurs. For example, a board approves the operating budget but does not hire the faculty and mid-level administrators who carry it out. Ideally, boards should focus on review and authorization, the administrators on recommendation and management, and both on evaluation.

Second, most boards include highly successful, powerful members of the business community who may grow impatient with the slower pace of decision making and consensus building typical of academic institutions—especially in budgeting, capital projects, bond issues, and financial planning. Trustees may possess expertise in running businesses similar to bookstores or dining services, and thus be tempted to "jump in and solve the problem" when one occurs. Doing so not only erodes the confidence of mid-level administrators, it also causes the board to become a *de-facto* board of appeals every time a disagreement arises. At the same time, however, trustees must not be so uninvolved in serious issues that they abdicate their roles as policy makers and strategic auditors.

FUNDAMENTAL QUESTIONS FOR BOARDS. In exercising effective oversight of the institution's finances, board members should consider four central questions that relate to mission, financial planning, and available resources.

1. What are the institution's strategic vision and current priorities? Financial policies gain relevance when the board and president have developed a mission and strategic vision that set basic directions for teaching, research, and service. The board can articulate this vision in a formal plan with a mission statement, continuing and specific objectives, concrete programs, and assignments of responsibility. The plan also can be informal and defined by periodic statements of academic and administrative priorities. In either case, the plan will be responsive to changed circumstances or shifts in organizational direction.

Clear goals for the institution are essential ingredients for developing programs and setting effective budgets. As *Alice's Adventures in Wonderland* reminds us, "If you don't know where you're going, any way will get you there." In other words, know the destination of the institution, and chart the best path there.

The process by which an institution determines its vision should underlie the board's discharge of its financial responsibilities. Many boards are comfortable with an informational or consultative model in which they discuss financial data and tentative decisions with key campus constituencies and then determine the vision and construct the budget in partnership with the administration. This model is prevalent in public institutions that share power with state agencies.

In a more open, participative model, faculty and staff typically draft the plan and budget by forming a committee, holding hearings, and making recommendations to the chief executive and trustees who have the final authority. With this model, the process obviously is more open and so becomes slower. It takes time to prepare appropriate communications materials for the campus, organize meetings, solicit feedback, answer questions, and assimilate suggestions. Yet a vision developed with genuine participation is more likely to be understood and accepted by more people. A participative process also can help educate the campus community to the terms and concepts of financial management. Further, the rationale for core priorities may become clearer when they are better understood by greater numbers of the campus community.

To illustrate, consider the experience of Bowdoin College in 1991 when it established a budget and financial priorities committee of students, faculty, administration, and support staff. This committee develops and recommends long-term priorities relating to all aspects of college life, including academic programs, facilities maintenance, and information technology. Committee members also must recommend how such priorities are funded—a responsibility that further enhances their accountability. Because the committee draws from all constituencies and listens to all comments and suggestions, it helps create institutionwide ownership of the strategic plan and subsequent emerging priorities.

2. How are the vision and priorities reflected in long-term financial plans and policies? Trustees must ensure the institution's resources match its aspirations. Revenues and expenses must be forecast over five to ten years to detect if the budget will be balanced when it includes new priorities. Financial forecasts of various assumptions—inflation, annual-fund and capital-campaign expectations, state appropriation levels, and formula funding, for example—must be clear and convincing. A soundly constructed financial plan can encourage or dissuade the board's ambitions *before* it commits scarce resources. A plan must be dynamic and flexible enough to accommodate inevitable change brought about by unforeseen events as well as by conscious decisions.

An endowment is a long-term, continuing resource to the institution. The board must diversify investments adequately to provide a total return sufficient to help operate the institution and increase overall endowment size. At the same time, it must avoid dangerous speculation. Board members must be especially careful to guard against even the appearance of a conflict of interest by recusing themselves from investment decisions that affect their personal portfolios. Annual spending of income from the endowment—typically expressed as a percentage of the current or lagging average of the endowment's market value—must preserve the purchasing power of the endowment while funding the institution's key priorities.

One rule of thumb is that over time, the yearly total return of the endowment in income and gains must be equal to or greater than spending for the budget plus inflation. Thus, an institution would meet this test if it operated with a 10 percent total return that spent the equivalent of 5 percent of the market value when inflation is 3 percent. This is a long-term policy with occasional losses permitted during years of extraordinarily high inflation or low investment returns, and provided that purchasing power is restored when economic conditions are more favorable.

Endowments typically are earmarked to achieve two broad goals:

- ***Budget Support.*** Many independent institutions could not balance their operating budgets without support from their endowment. Effective boards avoid the temptation to spend too much from the endowment in difficult budget years and instead look first to alternative revenue sources and expense reductions.

- ***Capital Projects.*** One of a board's prized—and most enjoyable—responsibilities is assessing the condition of the physical plant. Is it adequate, given the institution's mission and vision? Can the institution afford to maintain or enhance it, given current and projected revenues and expenses? Authorizing a bond issue to fund construction commits the institution to debt service over many years, although state authorities sometimes relieve public colleges and universities of this burden. A capital project also obligates the institution to a consistent maintenance program it must sustain, even when the budget is pressured by competing needs. However, the long-term commitment to a new or renovated building meshes nicely with a board's long-term perspective.

ONE RULE OF THUMB: OVER TIME, THE YEARLY TOTAL RETURN OF THE ENDOWMENT IN INCOME AND GAINS MUST BE EQUAL TO OR GREATER THAN SPENDING FOR THE BUDGET PLUS INFLATION.

In considering endowment policies and capital projects, the board and administration must maintain an equal commitment to current obligations and future needs. As Regina Herzlinger wrote in the *Harvard Business Review*, "[An institution] should practice intergenerational equity by conserving its capital so present and future generations have equivalent opportunities to benefit from its resources.... Maintaining intergenerational equity usually requires that the institution earn a profit to permit it to replace its net assets. In this case, profit is not a return to the owners but an allowance for the replacement of depleted capital."

3. How are the vision and priorities reflected in annual operating and capital budgets and other financial statements? Boards must make difficult choices in allocating resources among competing priorities—salaries, financial aid, construction and maintenance, debt service, and information technology, to name a few. Public institutions also work with state boards and legislative committees for program authorizations and appropriations. The adage "to govern is to choose" never is more accurate than when governing boards annually wrestle with the essential paradox of overseeing a budget that attempts to stretch limited resources to cover unlimited needs.

WHEN SETTING POLICY THAT AFFECTS THE INSTITUTION'S FINANCES, A GOVERNING BOARD MUST LOOK AHEAD TO THE NEXT BUDGET AND BACK TO AUDITED FINANCIAL STATEMENTS AND OTHER RECORDS.

For example, consider need-blind admissions policies. While they may be laudable, they must be supported by sufficient endowment income or other revenues. Additionally, such admissions policies require a board to establish institutionally awarded financial aid as a high priority, which in turn requires the board to reallocate resources or engage in fund-raising to pay for the policy. When setting policy that affects the institution's finances, a governing board must look ahead to the next budget (Are projected resources sufficient to find the policy?) and back to audited financial statements and other records (What did the policy cost to implement last year?).

A central responsibility of the board is to determine if the institution is committing its budgeted financial resources to support the board's stated priorities. To do so, trustees may consider the following factors.

- ***Affordability.*** Examine the share of total revenue supplied by student fees and the effect of financial-aid policies on net revenue.

- ***External Support.*** Study trends in revenue earned from annual giving, government appropriations, and other sources.

- ***Role of Teaching.*** Consider how much of the budget is devoted to teaching and academic support, including libraries, laboratories, and information technology.

- ***Quality of Student Life.*** Determine the expenses for student services and such auxiliary enterprises as dining facilities and dormitories.

- ***Role of Research.*** Examine the number and size of government and foundation-sponsored research projects and programs.

- ***Physical Assets.*** Study the expenses incurred for physical plant operation and maintenance and new construction and other capital projects.

- ***Human Resources.*** Consider the institution's expenses for employee training, tuition reimbursement, and compensation and benefits.

Regardless of the degree to which the institution commits resources to its mission, vision, and priorities, the president should work with trustees to set budget goals and identify budget constraints. Some of the goals might include balancing the budget, investing a certain share of the total budget on academic programs, limiting tuition increases to the rate of consumer inflation, and maintaining the number of faculty positions should staff cutbacks become necessary. The board also should be assured that institutional leaders have determined the fixed and variable costs of new or expanded programs and that (1) sufficient revenues exist to cover those costs, or (2) funds will be reallocated within the budget—a practice also known as "growth by substitution."

In addition, various committees of the board help determine the institution's financial priorities. The finance committee has the major responsibility for budget review, but committees on academic affairs, enrollment, student affairs, and physical plant also have input into various aspects of the budget process. Sometimes the finance committee chair will brief members of other committees on the budget, especially if they have specific concerns; often this individual will brief the whole board as well. The audit committee is responsible for judging the accuracy of financial statements that disclose, among other things, whether actual revenues and expenses met budget.

4. *Is the institution sustainable?* This is the proverbial "bottom line" question for boards, and they must answer it on two levels: immediate survival and long-term goals and priorities. How can trustees diagnose financial distress? The following factors provide some direction.

- ***Budget Deficits.*** Nothing speaks more loudly than a deficit in the annual operating budget, but not all deficits are equal in their importance. For example, sporadic small deficits often are no cause for alarm, nor are large deficits in any one year if sufficient reserves exist to close the gap.

  Budget deficits often occur when boards approve long-term financial commitments (buildings and programs, for example) that neglect to provide corresponding stable and sustainable revenue sources. One-time grants or gifts may help for the short term, but they cannot support permanent additions to the budget.

  Leaders of most nonprofit organizations would be disturbed if they discovered an operating-fund deficit that persisted for two consecutive years, was greater than the previous year, or equaled more than 10 percent of total revenue. Trustees should be mindful of three limitations of using budget deficits to signal sustainability: (1) The institution may have endowment or other resources to avert a deficit crisis; (2) deficits can be orchestrated by accruing expenses from another fiscal year or deferring revenues into another year; and (3) interfund borrowing or transfers can obscure deficits.

- ***Cash-Flow Problems.*** Colleges and universities may have severe cash-flow problems despite a balanced budget. Meeting payroll and other short-term expenses can be challenging when cash inflows surge two or three times each year as students and parents pay tuition bills. An institution may have adequate revenues for the year but not during crucial periods when bills are due. Inadequate cash flow threatens the survival of many small colleges almost as much as an unbalanced budget. During economic downturns, state governments may encounter slower or lower tax collections that pressure the cash flows of public institutions, too.

INADEQUATE CASH FLOW THREATENS THE SURVIVAL OF MANY SMALL COLLEGES ALMOST AS MUCH AS AN UNBALANCED BUDGET.

- ***Drop in Student Enrollment.*** Because tuition and fees are a primary source of revenue, student enrollment is a key financial concern. On average, tuition and fees represent more than 50 percent of total revenue. Smaller, more modestly endowed private institutions can derive 90 percent or more of their revenue from this one source. Public institutions also are becoming more dependent on student charges as state appropriations decline. And as an institution's budgetary dependence on tuition and fees grows, a drop in student enrollment becomes an increasingly significant criterion of financial distress. Enrollment slides are serious, especially when expenses continue to rise and the institution has few reserves. Bond-rating agencies also consider student demand to be among the most critical factors in assessing creditworthiness, especially in institutions with high dependence on tuition.

- ***Increase in Tuition Discounting.*** Financial aid often is closely linked with enrollment. Boards should examine not only how many students enroll but also how much financial aid is required to recruit them. Such aid is a discount against tuition and can offset wholly or partly any revenue gained from increased enrollment. It is not unusual for private institutions to invest one-third or even one-half of their tuition revenues in financial aid. "Net tuition," or how much revenue remains after deducting financial aid, is a growing concern of many boards.

- ***Risk Management.*** The traditional view of risk management relates to adequate insurance coverage for trustees and officers, general liability, fraud protection, health care, and natural disasters. Risk management also measures how well the institution is prepared to cope with emergencies—ranging from weather to public relations—that have adverse consequences on external financial support or total expenses. [A separate title in the *Board Basics Series* addresses this topic in greater depth.]

PROBLEMS OCCUR WHEN BOARDS MUST MEDIATE BETWEEN AN AMBITIOUS PRESIDENT AND A CAUTIOUS CHIEF FINANCIAL OFFICER.

- ***Staffing.*** On personnel matters, board members must have confidence in the president and senior administrators. The board must monitor and periodically update financial policies that delegate authority to sign contracts and purchase property.

Problems occur when boards must mediate between an ambitious president and a cautious chief financial officer. Both persons are crucial to the institution's well-being, and boards are wise to develop succession plans if either leaves the institution. Such plans ensure that basic financial decisions continue unimpeded. Not only is this essential to maintaining smooth operations, but it also assuages bond-rating agencies, investment bankers, public officials, and other external constituencies if either a chief executive or chief financial officer departs.

MONITORING PERFORMANCE. As they address the foregoing central questions, boards also should agree on a set of strategic indicators that measure the institution's performance. The most salient indicators relate to the amounts and rates of increase or decrease in the following conditions:

- specific revenue sources, especially student fees discounted for financial aid and government appropriations;
- expenditures on teaching, institutional support, and student services;
- admissions applicants, acceptances, and yield;
- endowment market value and spending rate;
- student-to-faculty ratios and average class size;

- deferred maintenance as a proportion of the replacement value of physical plant; and
- alumni giving in terms of participation rates and average gift size.

Comparison Groups. The acronym C-A-S-H suggests four ways a board can evaluate its strategic indicators. Revenues, expenditures, and other data can be analyzed comparatively with similar institutions, with reference to a national average or industry standard, and historically within the same institution over time.

Identifying a valid comparison group of peer institutions is tricky. The peer institutions must be true competitors, and the group should be large enough (ten or more) to provide significant data and negate the accounting differences that make single-institution comparisons invalid (for example, varying recognition of depreciation and inconsistent assignment of expenses to teaching). Public colleges and universities often compare themselves appropriately with other institutions in their athletic conference or state system.

The data from a comparison group are most useful for gaining a general perspective, although institutions sometimes index specific parts of their budget. For example, one college may set student fees at the median of competitor colleges. Other colleges set faculty salaries at levels that maintain a certain position within their comparison groups. Bowdoin College strives to pay faculty salaries at the average of the fourth, fifth, and sixth highest institutions within its 18-college comparison group.

Data Sources. Obviously, the board must rely on the president and senior officers for data and analysis about these indicators. An office of planning or institutional research also can be helpful. The full board should receive a financial update at every meeting, and the finance committee should be briefed regularly by a senior financial executive in meetings, by telephone, and via mail. Other effective communication vehicles include a financial section of the institution's Web page, a "fact book," and e-mail. Yet if the full board, a board committee, or individual members seek independent and corroborative evidence, they should examine the following:

- the institution's long-range strategic plans, particularly the mission statement, cost analysis, and evaluation criteria;

- budget documents that explain the theory underlying the annual budget, estimated revenues and expenses for the next year, and a forecast for one or two additional years;
- audited financial statements and the related management letter that suggests how financial and administrative systems can be improved;
- self-studies prepared for institutional and departmental reaccreditation, as well as the eventual reaccreditation report;
- reports on asset allocation, investment performance, and the portfolio's risk-return profile;
- periodic internal administrative reports on admissions, financial aid, buildings and grounds, employee compensation and development, and student life; and
- higher education periodicals, books, and special reports.

CONCLUSION. Colleges and universities are under great pressure to deliver high-quality education in an era of skyrocketing costs and fierce competition for the most able students and faculty. In this environment, board members face great challenges to ensure the survival and improve the accountability of their institutions. The financial responsibilities of governing boards never have been more important. Trustees must insist that the institution they oversee has a clear mission, complementary short-term and long-term financial plans, and proper financial controls.

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This publication is part of **Board Basics**, an AGB series devoted to strengthening the effectiveness of governing boards and trustees. Board Basics comprises several topic clusters—The Fundamentals, Financial Matters, Fund-Raising, Academic Affairs, Leadership, Strategic Decisions, and Effective Committees—each of which contains several booklets. Several assumptions underlie the series:

- Academic trusteeship grows increasingly ambiguous, and trustees need concise, accessible, and focused information to help them carry out their complex fiduciary and stewardship responsibilities.
- Basic principles of trusteeship remain constant across higher education, regardless of institutional type, size, and mission. The series highlights these general principles to provide trustees with a core of knowledge they can apply to their individual institutions.
- The series addresses the distinguishing characteristics of academic trusteeship, especially as it differs in scope, substance, and focus from corporate directorships and other board service.

AGB and the authors welcome comments and suggestions to improve this publication and others in the series. Call AGB publications at 800/356-6317 or visit our Web site at http://www.agb.org for more information.

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